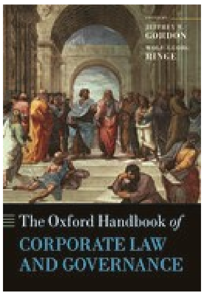
Majority Control and Minority Protection

Zohar Goshen
Columbia Law School, zohar.goshen@law.columbia.edu

Assaf Hamdani
Hebrew University of Jerusalem



The Oxford Handbook of Corporate Law and Governance
Jeffrey N. Gordon (ed.), Wolf-Georg Ringe (ed.)

https://doi.org/10.1093/oxfordhb/9780198743682.001.0001
Published: 2015 **Online ISBN:** 9780191803819 **Print ISBN:** 9780198743682

CHAPTER

17 Majority Control and Minority Protection

Zohar Goshen, Assaf Hamdani

https://doi.org/10.1093/oxfordhb/9780198743682.013.25 Pages 449–469
Published: 06 August 2015

Abstract

This chapter examines legal issues concerning majority control and minority protection in firms with concentrated ownership governance structures, with particular emphasis on the tradeoff between the goals of protecting minority shareholders and allowing controllers to pursue their vision and how corporate law should balance these conflicting goals. Focusing primarily on Delaware corporate law, it suggests that holding a control block allows majority shareholders to pursue their idiosyncratic vision in the manner they see fit, even against minority investors' objections. Idiosyncratic vision refers to the subjective value that entrepreneurs attach to their business idea or vision, and this chapter considers its role in the value of control. It also discusses the perils of asymmetric information and differences of opinion, as well as the risk of agency costs for minority investors.

Keywords: majority shareholders, minority shareholders, idiosyncratic vision, Delaware corporate law, asymmetric information, investors, entrepreneurs, agency costs, controlling shareholders, governance structure

Subject: Company and Commercial Law, Law

Series: Oxford Handbooks

Collection: Oxford Handbooks Online

1 Introduction

MINORITY protection is a central issue for legal systems that regulate firms with a controlling shareholder. Concentrated ownership is the predominant ownership structure of public companies around the world, and even in the United States and the United Kingdom, where dispersed ownership is the norm, firms with concentrated ownership make up a substantial portion of publicly held companies. In this organizational structure, a person or entity—the controlling shareholder—holds an effective majority of the firm's voting and equity rights.[1]

Despite the costs of illiquidity and suboptimal diversification associated with being a controlling shareholder, concentrated ownership remains prevalent throughout the world. Several theories attempt to make sense of this apparent anomaly. These theories identify justifications for the presence of controlling shareholders and offer explanations for cross-jurisdictional differences in the prevalence of the concentrated ownership structures.

The prevailing view posits that controllers are drawn to what corporate lawyers and economists call "private benefits of control."[2] These benefits can be both pecuniary, where controlling shareholders may be able to engage in self-dealing transactions or tunnel funds, and nonpecuniary, such as enhanced social status and ego.[3]

p. 450 In this chapter, we provide a brief summary of our new explanation of the value of corporate control for controllers–entrepreneurs and the prevalence of concentrated ownership.[4] We then use our new framework to offer a blueprint for the corporate law regime governing firms with controlling shareholders. In our view, holding a control block allows the entrepreneur–controlling shareholder to pursue her business idea (i.e., any concept that she genuinely believes could produce an above-market rate of return) under conditions of asymmetric information and differences of opinion in the manner she sees fit, even against minority investors' objections. We call the subjective value entrepreneurs attach to their business idea or vision the entrepreneur's *idiosyncratic vision*.

Both our novel explanation and the existing ones for the prevalence of controlling ownership have a foundation in reality, and indeed, both may be at play in a single firm. While pecuniary and nonpecuniary private benefits of control may be a strong motive for many controlling shareholders, the pursuit of their idiosyncratic vision notwithstanding investors' objection may motivate others to hold a control block. Moreover, our theory can explain the prevalence of concentrated ownership even in countries with strong investor protection and offers important implications for corporate law governing firms with controlling shareholders.

Corporate control matters in our framework because business ideas take time to implement. The successful implementation of a business idea requires many decisions, ranging from day-to-day management issues to major strategic choices. Perhaps the most important decision is whether to continue a project notwithstanding some setbacks. Due to either asymmetric information or differences of opinion between entrepreneurs and investors, there may be substantial disagreements over whether the project should be continued and in what fashion. The entrepreneur will therefore want to retain control over a wide range of management decisions to successfully pursue her vision. In short, control enables controlling shareholders to capture the value that they attach to the execution of *their* vision.[5]

Henry Ford's story is the best illustration of the importance of control for entrepreneurs-controlling shareholders in pursuing their idiosyncratic vision. Ford did not invent the automobile, nor did he own any valuable intellectual property in the technology. Therefore, he had to compete with hundreds of other entrepreneurs who were attempting to create a "horseless carriage." Ford had a unique vision regarding car production, however. In the first firm that Ford founded, the Detroit Automobile Company, investors retaining control resulted in tensions over the automobile production timeline. While Ford's investors demanded that cars be immediately produced and sold, Ford insisted on perfecting the design prior to production. This difference of opinion led to delays, frustration on both sides, and the eventual shutdown of
p. 451 the firm by its investors.[6] Ford's second attempt, the Henry ↳ Ford Company, was also controlled by investors. Again, after designing a car, Ford resisted the investors' pressure and did not move swiftly into production. Eventually, his obstinacy led to the investors replacing Ford with Henry Leland, changing the company name to the Cadillac Automobile Company and producing the car designed by Ford with great success.[7] Finally, on his third attempt—the Ford Motor Company—Ford insisted on retaining control. This

time, with no outside investor interference, Ford transformed his ideas of car design and production (i.e., his idiosyncratic vision) into one of the greatest corporate success stories of all time.[8]

While Henry Ford's story demonstrates the perils of asymmetric beliefs and investor control from the entrepreneur's perspective, asymmetric information also introduces the risk of agency costs for investors. Entrepreneurs are not always right. For Henry Ford's investors, it was difficult to know whether Ford was pursuing a viable vision or simply wasting valuable money and time on an unattainable project. More importantly, entrepreneurs might behave opportunistically. An entrepreneur may continue a failing project out of personal interest, or, in the type of concentrated ownership structure discussed in this chapter, exploit her dominant position to consume private benefits at the expense of minority shareholders. She can, for example, pursue pecuniary benefits by entering into self-dealing transactions,[9] engaging in tunneling,[10] or employing family members. In addition, she can also capture nonpecuniary benefits such as boosting her ego and social or political status through her influence on corporate decisions.[11] These risks, called agency costs, arise when the interests of agents and their principals are not perfectly aligned.

Protecting investors against agency costs is in an unavoidable conflict with allowing entrepreneurs to pursue their idiosyncratic vision. The more freedom an entrepreneur has to pursue her business vision, the more exposed the investors are to agency costs, and vice versa. Entrepreneurs and investors allocate control and cash-flow rights to resolve the inevitable trade-off between agency costs and idiosyncratic vision. In a firm with concentrated ownership, the entrepreneur must hold a substantial fraction of cash-flow rights to secure the ability to pursue her vision. This allows the controller to pursue her vision while reducing (due to the controller's considerable share of cash-flow rights) minority shareholders' exposure to management agency costs. The controlling shareholder is willing to bear the costs of holding a large block of shares in exchange for gaining incontestable control, which enables her, through the pursuit of her idiosyncratic vision, to generate an appropriate return on her investment and effort while simultaneously generating
p. 452 pro-rata benefits for investors. ↳ But, although controlling shareholders hold control primarily in order to *increase the size of the pie* (via the pursuit of vision), there is a risk that they might attempt to dictate the *pie's distribution* (via the consumption of private benefits). Minimizing this risk, i.e., the risk of control-agency cost, is at the center of minority protection.

On the policy level, our theory of the value of control for entrepreneurs offers important lessons for the regulation of firms with controlling shareholders. The existing corporate law literature associating control with consumption of private benefits solely focuses on minority protection from agency costs. However, within our framework of the concentrated ownership structure, controlling shareholders' right to pursue their idiosyncratic vision also plays, and should play, a critical role in corporate law. Specifically, any legal regime governing firms with controlling shareholders encounters an inevitable trade-off between the goals of protecting minorities and allowing controllers to pursue their idiosyncratic vision. Corporate law must balance these conflicting goals instead of pushing for only one of them. Our analysis in the remainder of this chapter focuses mostly on Delaware, the jurisdiction with the most developed corporate case law and jurisprudence.

2 The Trade-off between Minority Protection and Controller Rights

As delineated above, corporate law should recognize the controller's right to pursue her vision while simultaneously protecting investors from expropriation through self-dealing and other methods of value diversion. Finding the appropriate doctrinal balance is challenging because of the inevitable conflict between minority protection and controller rights, especially since distinguishing between legitimate corporate decisions that enhance business vision and those that lead to unequal distributions can be difficult. The same asymmetric information and diverging beliefs that make the contracting process between investors and entrepreneurs challenging makes the enforcement of the rules against self-dealing challenging as well. Minority-protecting measures may lead to costly errors, and efforts to police the prohibition on non-pro-rata distributions may require legal or governance measures that would undermine the controller's management rights.

To illustrate the interplay between minority protection and controller rights, assume that the entrepreneur owns 60% of a firm. The entrepreneur genuinely believes that a specific component produced only by one particular company is necessary for the development of a new product. It so happens, however, that the company producing the component is 100% owned by the entrepreneur. Accordingly, the entrepreneur wishes for her 60%-owned firm to buy the components from her wholly owned company. If the entrepreneur were the sole owner of both firms, she could simply buy the component under whatever terms she desired. But, with investors owning 40% of the firm's shares, there is an understandable suspicion that the entrepreneur is abusing this transaction to divert value from minority shareholders to her wholly owned corporation, and ultimately, to herself.

This illustration underscores the at-times opaque line between unfair self-dealing and business decisions
p. 453 that are necessary for implementing the controller's vision to the ↳ benefit of the controlling and minority shareholders alike. Protecting the minority against inappropriate value diversion requires some constraints on the entrepreneur's ability to exercise control. These constraints can take the form of ex post review by courts with regards to the fairness of the transaction, or an ex ante requirement to secure approval by a majority of the minority shareholders.[12] Thus, the need to provide the minority with protection against agency costs will necessarily require curtailing some of the controller's freedom to pursue her idiosyncratic vision that she would have otherwise enjoyed as a single owner.[13]

One might argue that constraining self-dealing need not interfere with the controller's ability to pursue her vision. After all, the argument goes, if the controller does not intend to expropriate the minority, why would she care about the extra supervision? If the transaction is on arm's length terms, the court will find it to be fair ex post,[14] or minority shareholders will grant their approval ex ante. This argument would be correct in an ideal world without transaction costs. In the real world, however, plaintiffs sometimes bring suits without merit[15] and courts make mistakes.[16] Likewise, under a rule that requires a majority-of-minority vote, minority shareholders might strategically attempt to hold out or simply err in evaluating the proposed transactions.[17] This conclusion also applies to other prophylactic measures required for creating an effective minority-protection regime.[18] Accordingly, protecting minority shareholders against agency costs inevitably interferes with the controller's right to pursue her business vision.

The trade-off between minority protection and controller rights has obvious implications for the design of corporate law. It requires lawmakers and courts to seek an optimal balance between minority protection and controlling shareholder freedom to make managerial decisions. More practically, the nature of minority protection should depend on enforcement considerations. Enforcing a given protection may be too costly not only because of the direct compliance costs incurred by corporations or courts but also due to the unavoidable cost of interfering with the entrepreneur's pursuit of her idiosyncratic vision.

p. 454 ## 3 Controller Rights

Analysis of the controlling shareholder's side of the corporate contract focuses on the scope of the controller's rights vis-à-vis the scope of minority protection. The division of cash-flow rights and control rights is a zero-sum game between entrepreneurs (controlling shareholders) and investors (minority shareholders), such that any freedom granted to the controller to pursue her vision will increase minority exposure to agency costs, and vice versa.

3.1 Property Rule Protection: Preserving Control

To preserve the entrepreneur's incontestable control and the ability to pursue her idiosyncratic vision, her right to make management decisions should be afforded property rule protection.[19] In this context, property rule protection means that the market (i.e., minority shareholders) or courts cannot unilaterally take control rights away from the controller in exchange for an objectively determined compensation. Instead, the controller can prevent a non-consensual change of control from ever taking place at all.[20]

Property rule protection of controller rights has clear implications analogous to standard private property protections. For example, controllers cannot be forced to sell their control block even when doing so would clearly benefit the corporation or its minority shareholders.[21] Furthermore, the controller is generally free to exit her investment by selling her control block whenever she wants and for whatever price she sees fit.[22]

Property rule protection for controlling shareholder management rights extends further to a broad range of corporate actions. Controllers can lose control not only when they sell their shares, but also when the
p. 455 company takes action—such as issuing shares—that dilutes ↳ their holdings. Companies with controlling shareholders cannot take actions that would cause the controller to lose her control, even when doing so would benefit the corporation or minority investors.

Consider the following hypothetical. A bank must increase its capital to meet new capital adequacy requirements. The bank has two options: issuing new shares or selling one of its subsidiaries. The bank's controlling shareholder, who owns 51% of the shares, has her own liquidity problems that prevent her from buying additional shares of the bank. Issuing new shares would therefore dilute the controller and may cause her to lose her controlling position. How should the board decide between the two options? At first glance, directors' fiduciary duties seem to require them to choose the option that best serves the company's interests while disregarding the controller's interest in preserving control. Under Delaware case law, however, the board might be prohibited from taking steps that would make the controller lose corporate control "in the absence of a threatened serious breach of fiduciary duty by the controlling stockholder."[23] Therefore, the board may decide to sell a subsidiary merely because issuing new shares would force the controller to lose control.[24]

This outcome runs against the traditional notions of shareholder value maximization because it allows value-reducing actions in light of a need to protect the controller's rights. Yet a regime under which minority shareholders, the board, or courts could compel the controller to lose control—whether by a forced sale, dilution, or any other action—is inconsistent with the need to provide controllers with a property rule protection for their right to make managerial decisions and pursue their business vision. It is important to note that this outcome is not justified by the need to provide controllers with private benefits to reward them for their willingness to monitor management. Instead, it is based on the parties' mutual consent ex ante on an arrangement that would enable entrepreneurs to pursue their idiosyncratic vision to the benefit of both minority investors and the entrepreneur.

3.2 Management Rights: Business Judgment Rule and Board Composition

Application of the business judgment rule strengthens the controlling shareholder's control over management decisions in pursuit of her idiosyncratic vision. The business judgment rule embodies the principle that courts should generally refrain from interfering with business decisions made by controllers
p. 456 or their representatives. The entrepreneur–controller ↳ is willing to make a significant equity investment in exchange for the right to pursue her business vision. The allocation of control particularly matters in light of the asymmetric information and differences of opinion between the entrepreneur and the investors/market. Some of the greatest breakthroughs in business ideas were "crazy" before they became "visionary." These ideas would have never come to pass in the absence of control. What then should be the nature of protection of idiosyncratic vision?

Application of the business judgment rule recognizes the controlling entrepreneur's right to exercise control over any issue that could affect the firm's value. Controlling shareholders should be free to set the firm's direction and make all management decisions. This includes the right to assume a managerial role (if the controller is an individual) as well as the right to appoint and fire managers. This has two implications for corporate law doctrine and policy. First, courts should generally refrain from interfering with business decisions that controllers or their representatives make—in other words, follow the business judgment rule.[25] The controller–entrepreneur retains control because of her expectation that asymmetric information or differences of opinion would induce investors to make decisions that would destroy her vision. The existence of asymmetric information and differences of opinion, moreover, should give courts pause before they attempt to intervene in business decisions. Like investors, courts may make decisions or take actions that, from the entrepreneur's perspective, would destroy her vision.

The business judgment rule is often justified on the grounds that judicial review of non-conflicted transactions is unnecessary in a concentrated ownership environment where the controlling shareholder's significant equity stake provides sufficient incentive to maximize value for all investors.[26] The need to allow the entrepreneur–controller to pursue her idiosyncratic vision, however, provides another explanation for the business judgment rule. The entrepreneur should have the freedom to implement her business plan even when investors and courts believe that such a plan is not value-enhancing.

Moreover, controllers' management rights have significant implications for corporate governance reforms designed to enhance board independence at firms with controlling shareholders. Traditionally, the controllers' voting power enables them to appoint any candidate they wish to the board. Recent corporate governance reforms, however, constrain the controllers' power to appoint directors. Listing requirements, for example, require boards or board committees to maintain a certain percentage of directors who are independent, not only from the company, but also from the controller.[27] Some legal systems go even further and empower minority shareholders to influence board composition by, for example, appointing their own representatives to the board.[28]

p. 457 These measures may be necessary to enforce the rule against self-dealing.[29] Board reforms aim to make the board more effective in monitoring those with power—the CEO or the controlling shareholder. However, asymmetric information and differences of opinion could prevent the controller–entrepreneur from credibly communicating her beliefs regarding her business vision not only to investors but also to skeptical independent board members. Thus, the need to balance controller rights and minority protection should also shape board reforms at firms with controlling shareholders. Since the presence of minority representatives, or even just fully independent board members, could interfere with the controller's ability to manage, the controller should at least have the power to appoint a majority of the board (which in turn should have the power to appoint the CEO and other managers). Presently, this necessity to balance those conflicting goals in firms with concentrated ownership is reflected in exceptions to the NASDAQ and NYSE listing rules for controlled companies.[30]

3.3 Right to Sell Control for a Premium

Whether controlling shareholders can sell their shares for a premium is one of the most important and controversial questions for firms with controlling shareholders.[31] Delaware recognizes the right of controlling shareholders to sell at a premium, subject to the restriction on selling control to a looter (the "market rule").[32] As explained above, the controller's right to sell at any time is the essence of her property right. But what about the right to sell for a premium not shared by minority shareholders?

The right to sell for a premium that is not shared by minority shareholders seems to contradict the idea of pro-rata value distribution. Nevertheless, the property rule protection counsels in favor of allowing
p. 458 controllers to sell their stake at a premium without sharing it ↳ with the minority shareholders. A key premise underlying the objection to controllers' right to sell for a premium is that a control premium serves as a proxy for private benefits and thus for minority expropriation. Under this view, imposing constraints on controllers' ability to sell for a premium would decrease the risk of inefficient sales motivated by the prospect of consuming private benefits at the expense of minority shareholders.[33]

As demonstrated above, however, a control premium is not necessarily a proxy for private benefits of control or the magnitude of minority expropriation. Instead, it could also reflect the value of the entrepreneur's idiosyncratic vision from either the buyer's or the seller's perspective. A seller who believes that she could earn above-market return on her shares would insist on a premium for selling her stake even if, had she stayed in control, she would have shared the profits from her realized idiosyncratic vision on a pro-rata basis with minority shareholders. In this sense, the seller is only taking a premium that is reflecting her pro-rata share of what she expects to receive. Consequently, a buyer that believes she could make an even greater above-market return on the new investment would be willing to pay such a premium. Thus, under our framework, the new controller's willingness to pay a premium for buying control does not suggest that she intends to exploit minority investors.[34]

However, corporate law in many jurisdictions appears to not subscribe to this rationale, instead imposing the so-called equal-opportunity rule that requires the buyer of more than a certain percentage of a firm's shares (usually around 30%) to make a tender offer that would take the shareholder to at least 50% share ownership.[35] To be sure, the equal-opportunity rule could protect the minority against a sale to a looter. (After all, we do not rule out the possibility that a control premium can reflect private benefits of control.) Moreover, it does not prevent the controller from selling her shares for a premium. Rather, it requires the buyer to offer the same premium to all shareholders. Yet, forcing the buyer to pay a premium to all shareholders raises the acquisition's total costs, thereby effectively barring a range of control-motivated transactions in which the buyer's expected increase in corporate value is insufficient to justify paying the premium demanded by the current controller to all shareholders. Thus, to the extent that a control premium is a proxy for business vision instead of private benefits, the costs imposed by the equal opportunity rule—in terms of discouraging efficient transactions—are expected to be higher.[36]

p. 459
4 Minority Rights

An analysis of the minority shareholder's side of the corporate contract focuses on the threats facing minority shareholders in corporate structures with a controlling shareholder and the type of protection that should be provided to enforce minority rights.

4.1 Type of Protection

Just as the protection of controllers' rights can exist as a property or a liability rule, minority shareholders can receive either property or liability rule protection against the possible exploitation by a controlling shareholder.[37] Under a liability rule, the controller can engage in self-dealing transactions without minority shareholders' consent, subject to her duty to pay an objectively fair price. This pecuniary commitment is supervised by courts. On the other hand, under a property rule, the controller cannot engage in self-dealing without securing the minority's consent, typically by a majority-of-the-minority vote.

Indeed, legal regimes could also leave protection against the controlling owner's self-dealings up to the unconstrained forces of the market, allowing for individualized solutions.[38] Shareholders would consider the risk of possible self-dealing as a threat to their investments when deciding on share ownership, leading the market to offer protections that mitigate this risk and assuage investor fears. However, markets are not perfectly efficient, and information costs undermine the efficacy of market-based solutions to the point of relatively diminishing standards.[39] Therefore, property- and liability-based protections are more efficient than a non-interventionist approach.

The need to balance controller and minority rights dictates the desirable form of minority protection. A property rule provides the minority with consent-based protection that is vulnerable to holdouts and other problems that can prevent the controller from getting minority approval even for a value-enhancing transaction, risking interference with the controller's management right. In contrast, a liability rule provides the minority with fair-compensation-based protection. This form of protection is vulnerable to judicial error, but it is less likely to interfere with the controller's management rights.[40]

Given the nature of these tradeoffs, a liability rule theoretically strikes the optimal balance between
p. 460 protecting the minority against agency costs and preserving idiosyncratic vision.[41] ↳ However, the actual effect of protections based on property or liability rules depends on the judicial system, market efficiency, and institutional investors of a given jurisdiction.[42]

In the presence of transaction costs, which include negotiation and adjudication costs, the choice between a liability rule and a property rule depends on which rule encourages and facilitates efficient transactions and discourages inefficient ones. In other words, a rule that facilitates the pursuit of idiosyncratic vision and the curtailment of agency cost should be implemented. A property rule, requiring approval by a majority of the minority of shareholders, involves high negotiation costs. These costs stem from dissemination of information and administration of the voting process, including the risk of strategic voting and hold-outs during the vote. On the other hand, although a liability rule does not rely on negotiations and thus does not entail high negotiation costs, negotiations do take place in the "shadow of the law."

Adjudication costs are relatively low in the presence of a property rule, where the courts need to only determine the procedural integrity of the shareholder approval process. Under a liability rule, the courts are called upon to examine the merits of a deal and opine as to its overall "fairness," which can require significant financial modeling by economic experts and has to rely upon a judicial system competent enough to navigate such complex cases. Costs of erroneous rulings are another type of adjudication cost. In the context of valuation, it is often the case that no "objective" market-based value exists, so the court must rely on a compilation of subjective assessments. In addition to increasing direct adjudication costs, this also increases the risks of mistakes, leading to high indirect adjudication costs as well.

Therefore, where negotiation costs are high due to a lack of sophisticated investors, and only a minimal level of judicial efficacy exists, the balance of negotiation and adjudication costs may weigh in favor of a liability rule. The opposite holds true where adjudication costs caused by judicial inefficiency outweigh negotiation costs. In some circumstances, negotiation and adjudication costs will point to the same direction, where either both will be high or both will be low. When both types of costs are high, a property rule is desirable because the risk of minority exploitation is sufficiently high that the private sector is better suited to respond. It is more likely that markets will react and improve minority protection than it is that governments will overcome path-dependency and improve courts' efficacy. Conversely, when both types of costs are low, a liability rule is desirable because the risks to investors are likely lower and liability protection provides greater ability to contract for alternative protections. An assessment of the relative weights of these two categorical transaction costs can indicate which rule is appropriate in a given context.

As demonstrated, there is no single efficient mechanism for the protection of the minority from corporate self-dealing. Rather, the choice between a property rule requiring majority-of-the-minority approval before every conflicted transaction and a liability rule allowing controller discretion subject to the court's objective evaluation of a transaction's fairness depends on the unique characteristics of each jurisdiction and how those characteristics impact the balance of the transaction costs. Ultimately, the rule that achieves
p. 461 the lowest ↳ transaction costs, thereby encouraging efficient transactions and discouraging inefficient ones, should be chosen.

4.2 Pro-Rata Share: Identifying Self-Dealing

The principal form of minority protection is the strong regulation prohibiting non-pro-rata distributions of a firm's assets. Minority shareholders' main concern is that the entrepreneur–controller will engage in self-dealing, tunneling, or other methods of capturing more than her pro-rata share of cash-flow rights. Therefore, in exchange for the controller's freedom to pursue her idiosyncratic vision by executing her business idea as she sees fit, the controller commits to share proportionally with the minority any cash flows that the project will produce. If she seeks any preference over the minority, she should negotiate with the minority investors and obtain their approval—either before entering the joint investment or before obtaining the preference. Otherwise, any non-pro-rata distribution will be subject to strict judicial scrutiny.[43]

A legal regime governing companies with controlling shareholders thus should accomplish two important tasks: first, create a workable distinction between neutral business decisions and self-dealing; and second, implement adequate mechanisms to govern self-dealing transactions. The distinction between self-dealing and other transactions has considerable judicial consequences. Under Delaware law, for example, this distinction determines whether a lawsuit challenging a transaction will be carefully reviewed under the plaintiff-friendly entire fairness standard or quickly dismissed under the defendant-friendly business judgment rule.[44] However, drawing the line between cases that deserve close scrutiny and those that do not is often difficult. Only rarely are cases straightforward; for example, when the controller sells her privately owned asset to the publicly traded firm that she controls, this would most likely constitute self-dealing. In many cases, however, it is unclear whether the mere fact that the controller's interests with respect to certain corporate actions are not fully aligned with those of the minority justifies close scrutiny.[45]

In considering the difficulty of characterizing a transaction as conflicted or non-conflicted, the *dividend distribution* question underlying the *Sinclair* case is instructive.[46] Should courts protect the minority against the risk that a controlling shareholder will use a pro-rata dividend distribution to advance her own interests? The *Sinclair* court answered this question with a clear answer: "No." Rather, it held that pro-rata dividend distributions do not amount to self-dealing and should thus be reviewed only under the business judgment rule.[47] Is this the most desirable outcome?

p. 462 For purposes of our discussion, assume that a pro-rata distribution could be used to satisfy the controller's own liquidity needs while denying the corporation highly profitable growth opportunities. In other words, assume that a pro-rata dividend distribution could be harmful to minority shareholders. Nevertheless, a legal rule that would aspire to supervise the controller and prevent such "abusive" distributions would be too costly.

Any rule that tries to scrutinize pro-rata dividend distributions would necessarily interfere with the controller's management rights and her ability to pursue her idiosyncratic vision. First, control over the firm's capital structure—the amount of capital that is required and how to finance the firm's operations—might be an integral part of implementing an entrepreneur's vision.[48] External intervention would therefore significantly interfere with the controllers' ability to make management decisions concerning their vision. Second, distinguishing "legitimate" dividend distributions from illegitimate ones is prone to errors because of asymmetric information and differences of opinion.[49] A court required to implement this distinction will have to assess the decision to pay dividends in light of its alternative, i.e., a decision to retain the dividend amount and invest it in potential projects. But, how will the court determine that the business opportunity abandoned by the corporation in order to facilitate the dividend distribution was indeed a good business opportunity? Will the court assume responsibility for the investment forced upon the controlling owner when it rules that the dividend is illegal? Lastly, even if courts were to accurately determine that a certain dividend is illegal, effective enforcement would itself require excessive intervention.

A disgruntled controller prohibited from paying a dividend may decide, for example, to avoid investments and instead deposit the dividend amount in the firm's bank account in order to distribute the same amount in the near future. Clearly, courts would not take away the controller's rights to make management decisions by forcing the controller to put the money to other, more profitable uses. In other words,
p. 463 effectively enforcing the ↳ non-distribution of dividends would ultimately require courts to abandon the business judgment rule.

Our discussion of *Sinclair* thus shows that the omnipresent tension between controller management rights and minority protection should shape the legal distinction between self-dealing and other transactions. The interests of controlling shareholders, to be sure, are not always fully aligned with those of minority investors. Yet not every conflict of interest justifies legal intervention to protect the minority.

4.3 Mid-Stream Changes

The preceding analysis provides support for Delaware's approach to self-dealing transactions. In this section, however, we explain that the same approach fails to protect minority shareholders against unilateral mid-stream changes to the firm's governance. Controlling shareholders can enjoy more than their pro-rata share of cash-flow rights by using their control to change the firm's governance arrangements mid-stream either directly—through changes in the charter or bylaws—or indirectly through a business combination, such as a merger. These changes could be inconsistent with the initial contract between the entrepreneur and investors.[50]

Consider, for example, the link between control and cash-flow rights. Under the one-share-one-vote rule, the controller's willingness to make a significant equity investment in order to secure his controlling position alleviates management agency costs and asymmetric information concerns. Once he raises funds from investors, however, the controller might be tempted to unravel this arrangement and find ways to preserve incontestable control without having to incur the costs associated with holding a large equity block.[51] A necessary element in any minority-protection scheme is, therefore, a protection against the unilateral, mid-stream changes to the firm's governance arrangement.

Indeed, on several occasions, minority shareholders did attempt to challenge such changes in Delaware courts, but without success. Courts refused to review these changes under the entire fairness standard, holding that the disparate *economic* impact of such changes on the controller did not amount to self-dealing as long as the *legal* effect was equal.[52]

This legal approach assumes that absent a clear restriction in the charter the controller has the right to change the allocation of control rights, thereby exposing the minority shareholders to agency costs. This approach may stem from the fact that Delaware courts use a single test for two distinct tasks—identifying self-dealing transactions and coping with mid-stream changes. However, mid-stream governance changes by controlling shareholders require a separate legal framework that first identifies cases of mid-stream changes, and second, makes a decision on the nature of protection that minority shareholders should enjoy.

p. 464

5 “Difficult Cases”

In this section, we consider two examples of transactions that have occupied courts and scholars alike and are not easily classified as dealing with either minority protection or controller rights. We first address freezeout transactions. Transactions of this type raise an inevitable and difficult tension between minority protection and controller rights. Second, we consider Delaware’s indeterminate approach concerning transactions in which both the controller and the minority sell, for equal consideration, 100% of the firm to a third party. In these cases, the need for minority protection is substantially weaker than in a freezeout transaction. At the same time, however, subjecting these transactions to closer scrutiny is unlikely to interfere with the controller’s right to secure her business vision.

5.1 Freezeout Transactions

In a freezeout transaction, the controlling shareholder of a publicly traded company buys out minority shareholders in order to take the company private. Although freezeouts have been subject to extensive analysis by legal scholars,[53] courts continue to struggle with the proper approach to regulating these transactions.[54]

Let us start with controller rights. Reviewing freezeout transactions through the lens of the inevitable conflict between minority protection and controller rights calls for providing controllers with an option to discontinue their partnership with the minority by taking the firm private. Buying out the minority may be required when keeping the firm public interferes with the realization of idiosyncratic vision,[55] or when a minority-protection regime proves too costly. Additionally, bolstering minority protection increases the likelihood that minority-protection measures will interfere with the controller’s freedom to pursue her vision, thereby creating an increased need to make it possible for controllers to take the corporation
p. 465 private.[56] Furthermore, there is an obvious difficulty in forcing an ↳ entrepreneur to “work” for others—minority investors—for as long as the investors wish or demand.[57] As a matter of legal doctrine, the need to provide the controller with an option to buy out the minority explains why Delaware courts have abandoned the requirement that freezeout transactions satisfy a business purpose test.[58]

For minority shareholders, however, freezeout transactions present a substantial risk of expropriation on a large scale. Controlling shareholders might opportunistically use the option to buy out the minority at unfair prices while taking advantage of their superior access to information concerning the firm’s true value.[59] The risk of expropriation calls for effective measures to protect minority shareholders in freezeout transactions.

However, a property rule protection—requiring a freezeout transaction to be conditional on a majority-of-the-minority vote—might undermine the controller’s ability to take the firm private in order to preserve her idiosyncratic vision.[60] Providing minority shareholders with the power to veto a freezeout may inhibit the goal of preserving the controller’s idiosyncratic vision in two respects. First, asymmetric information or strategic voting considerations might lead minority shareholders to vote against going-private proposals that are fair to the minority, thereby preventing the controller from an exit that could be vital for securing her business vision. Second, forcing the controller to keep the firm public has the same practical consequence as preventing dividend distribution. The court would have to interfere with management decisions, normally protected by the business judgment rule, to make sure the controller continues to work efficiently for the minority. Therefore, despite the high risk of expropriation, protection for minority shareholders in freezeout transactions should tilt toward a liability rule protection.[61]

A narrow reading of the Delaware Chancery Court's decisions in *CNX Gas* is consistent with favoring liability rule protection for minority shareholders in the context of a freezeout. It is possible to read the decision as requiring controlling shareholders to allow the board to use a poison pill to prevent a freezeout.[62] However, in a subsequent decision, the court ↳ seems to suggest that a poison pill is required only if the controller wishes to avoid judicial review of the transaction under the entire fairness standard.[63] In other words, the court allowed controllers to choose between a liability rule (judicial review) and a property rule (majority-of-the-minority vote and board veto). Allowing controllers to choose the legal regime that would apply to their going-private transaction seems consistent with the pursuit of idiosyncratic vision.[64] However, a regime that would compel controllers to subject their going-private transaction to a board's deployment of a poison pill would unnecessarily delay the freezeout by forcing the controller to replace the directors before merging.

p. 466

5.2 Sale to Third Party

The last example we consider is a transaction in which a third party, unrelated to the controller, buys all the company's shares from both the controller and the minority shareholders. In a transaction of this type, the controller—with a majority of the votes—can effectively force the minority to sell their shares (an implied drag-along option). Delaware courts have reviewed such transactions under different levels of scrutiny, depending on whether the controller and the minority received equal consideration. A sale to a third party raises genuine minority protection concerns when the consideration for the controller differs from that payable to the minority. Cases of this type create a conflict between the controller and the minority over the allocation of the sale proceeds. The controller might abuse her control over the target by bargaining with the third party buyer for a transaction that would benefit the controller at the expense of the minority. Not surprisingly, courts have subjected these transactions to the searching entire fairness test.[65]

In contrast, when a third party buyer offers equal consideration to all shareholders, minority shareholders should not need any protection. After all, with the largest equity stake and no apparent conflict, the controller could be relied on to work diligently to achieve the best feasible bargain. Yet Delaware case law on this issue is in remarkable disarray. While some decisions hold that these transactions do not require close scrutiny,[66] others have allowed minority shareholders to proceed with claims that the controller's need for ↳ cash—liquidity—created a conflict of interest that justified the court's review of the transaction.[67] Delaware courts' willingness to treat the controller's liquidity needs as creating a conflict that justifies judicial review is especially puzzling given their reluctance to treat the controller's liquidity needs as justifying judicial review in other contexts, such as pro-rata dividends.[68] Despite this seemingly inconsistent approach, the answer to the courts' treatment may lie, not in the nature of the conflict, but rather in the absence of business vision concerns.

p. 467

To begin, the controller can sell her block at a premium, thereby taking her share of the idiosyncratic vision, while enabling the minority to stay and share in the expected profits arising from the buyer's idiosyncratic vision. Alternatively, the controller can freeze the minority out to pursue her idiosyncratic vision in a wholly owned corporation, subject only to minority shareholders' right to receive an appraisal and entire fairness protection.[69] However, in contrast to these situations, the right to drag-along the minority does not protect the controller's idiosyncratic vision: The controller sells the corporation and ends her pursuit of the vision. Why, then, does the controller receive the right to force the minority to sell their shares along with her?

The answer is to allow the *buyer* to pursue her business vision in a wholly owned corporation. Instead of buying just the control block and then freezing out the minority subject to appraisal rights and entire fairness review, the buyer is willing to pay an equal premium to the minority to avoid the costs of a freezeout (i.e., time, effort, uncertainty, and litigation). In this scenario, the controlling seller who forces the minority to sell together with her assumes the role of an auctioneer. However, the controller has substantial holdings that normally induce her to maximize sale price. Thus, unlike the board of directors of a widely held firm that assumes the role of an auctioneer subject to both duty of loyalty and a heightened duty of care (i.e., *Revlon* duties),[70] the controller is only subject to the duty of loyalty.

Of course, the controller can avoid the role of an auctioneer by selling only her block. Obviously, she will simply do just that unless selling with the minority will result in a higher price. Put differently, the seller needs the minority to sell with her not because doing so will allow her to get the right price for her business vision, but because it will allow her to extract a higher share of the *buyer's* idiosyncratic vision. Accordingly, a controller cannot, for example, decide to take a cash offer over a higher valued bid while dragging along the minority to satisfy her liquidity needs, as this would be a breach of her duties as an auctioneer.

p. 468 Our framework thus calls for a different treatment of controllers' liquidity needs across transactions. A regime that imposes stricter scrutiny on dividend distributions would inevitably interfere with the controllers' management rights and might undermine their ability to preserve their idiosyncratic vision. These concerns cease to apply when the controller decides to sell the whole corporation to a third party. By putting her management rights up for sale, and also forcing the minority to sell, the controller signals that she is no longer concerned with the firm's implementing *her* idiosyncratic vision. Moreover, a sale to the highest bidder also means that asymmetric information is no longer an issue. In other words, employing judicial review is less likely to be costly here. Thus, even a relatively small risk of a conflict of interest may call for judicial scrutiny.

6 Summary

In publicly held companies with concentrated ownership, minority protection is a central concern of firm regulation. The presence of a controlling shareholder who owns only a fraction (albeit a majority) of cash-flow rights leads to potential agency costs for minority shareholders. In our framework, however, the need to protect minority shareholders from these inevitable agency costs must be balanced against preserving controlling shareholders' ability to pursue their idiosyncratic vision. This tension determines the type of protection that should apply to both the controllers' rights to make management decisions and the minority's rights to receive a pro-rata share of the firm's cash flows.

The value of control lies at least partially in the freedom for an entrepreneur to pursue her idiosyncratic vision associated with her business idea. This pursuit commonly takes place under the conditions of asymmetric information and differences of opinions. Consequently, this chapter discussed the need for property rule protection of the controlling owner's right to control. Property rule protection guarantees that minority shareholders or courts cannot unilaterally take control rights away from the controller, even for objectively fair compensation. The deferential business judgment rule further strengthens the controlling shareholder's ability to manage the company in pursuit of her idiosyncratic vision. Property rule protection extends to a broad range of corporate actions by the board, such as preserving the controlling shareholder's control even when it is not value-maximizing and protecting the ability of controllers to sell their control block for a premium.

On the other hand, the form of minority protection is also an important question for any legal regime. Minority protection can take two primary forms. Liability rule protection guarantees the minority shareholders that they will receive objective compensation for any unfair self-dealing by a controlling owner after an ex post entire fairness review by the courts. Property rule protection requires a majority-of-the-minority vote ex ante before any self-dealing transaction can be consummated in the first place, essentially guaranteeing the minority the subjective value of their consent. Transaction costs inform which rule should be utilized. Differences in the relative size of negotiation and adjudication costs based on the efficacy of judicial systems, efficiency of markets, and presence of institutional investors suggest a liability rule in some jurisdictions and a property rule in others.

Minority protection is characterized fundamentally by the principle of equal, or pro-rata, distribution. p. 469 Under this imperative, controlling shareholders have agreed to allow ↳ minority shareholders to share equally the proceeds arising from the controller's freedom to pursue her idiosyncratic vision. However, the application of this principle can be difficult in reality because of the frequently unclear division between conflicted and non-conflicted transactions. Finally, certain kinds of transactions, such as freezeouts and sales of 100% of a controlled company to a third party, present unique problems in achieving an optimal balance between securing the controller's ability to pursue her business vision and protecting the minority shareholders against agency costs and exploitation.

Notes

1 Our definition of concentrated ownership structure sets it apart from dual class firms and pyramidal structures. In the United States, Delaware courts have declined to quantify the precise percentage of stock necessary to constitute an "effective majority," choosing instead to engage in a factual inquiry of the exercise of actual control in each case. See, e.g., *Kahn v. Lynch Comm'ns Systems*, 638 A.2d 1110 (Del. 1994).

2 See Lucian A. Bebchuk, "A Rent Protection Theory of Corporate Ownership and Control", Nat'l Bureau of Econ. Research, Working Paper No. 7203 (1999), at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=168990 ; Simeon Djankov, Rafael La Porta, Florencia Lopez-de-Silanas, & Andre Shleifer, "The Law and Economics of Self-Dealing", 88 J. Fin. Econ. 430 (2008).

3 Another perspective takes a more positive view of concentrated ownership, emphasizing the governance role of controlling owners. This view argues that an investor's significant equity stake in a firm leads to more effective monitoring of management, and considers the private benefits associated with controlling ownership to be a reward or compensation for this monitoring. See, Ronald J. Gilson, "Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy", 119 Harv. L. Rev. 1641, 1663–64 (2006).

4 Our theory is fully developed elsewhere. See, Zohar Goshen and Assaf Hamdani, "Corporate Control and Idiosyncratic Vision", 125 Yale L. J. 560 (2016).

5 It is important not to confuse business vision with nonpecuniary benefits of control. Non-pecuniary benefits of control refer to the value (e.g., personal satisfaction, pride, fame, political power) that only the entrepreneur derives from the execution of her business idea. In contrast, the pursuit of business vision—if properly harnessed—will equally benefit all shareholders in the corporation.

6 M. Todd Henderson, The Story of Dodge v. Ford Motor Company: Everything Old is New Again, in Corporate Law Stories 40 (Mark Ramseyer ed., 2009).

7 Id. at 45.

8 Id. at 47.

9 See Djankov et al., *supra* note 2. Based on their study of 72 countries, the authors suggest that regulation of self-dealing transactions is best done by disclosure and ratification by disinterested shareholders. The analysis of the relative efficiency of rules regulating self-dealing was developed several years earlier. See Zohar Goshen, "The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality", 91 Cal. L. Rev. 393 (2003) [hereinafter Goshen, Controlling Self-Dealing] (introducing and applying the property rule/liability rule analysis to minority-shareholders' protection) [hereinafter Goshen, Controlling Self-Dealing].

10 See, e.g., Bernard Black et al., "Law and Tunneling", 37 J. Corp. L. 1 (2011); Simon Johnson et al., "Tunneling", 90 Am. Econ. Rev. 22 (2000).

11 See, e.g., Harold Demsetz & Kenneth Lehn, "The Structure of Corporate Ownership: Causes and Consequences", 93 J. Pol. Econ. 1155 (1985).

12 Goshen, Controlling Self-Dealing, *supra* note 9.

13 The single owner standard is useful not only as a benchmark for the protection of investors, but also as a benchmark for the controller's right to secure business vision. See, e.g., Lucian A. Bebchuk, "The Sole Owner Standard for Takeover Policy", 17 J. Leg. Stud. 197 (1988).

14 For a case in which the court concluded that a controlling shareholder had a strong idiosyncratic vision (without using this term, of course), and therefore approved a series of long-term self-dealing transactions as fair, see *Cookies Food Products, Inc. v. Lakes Warehouse Distributing, Inc.*, 430 N.W. 2d 447 (Sup. Iowa 1988).

15 Janet Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions", 43 Stan. L. Rev. 497 (1991); Roberta Romano, "The Shareholder Suit: Litigation Without Foundation?", 7 J. L. Econ. & Org. 55 (1991).

16 See Goshen, Controlling Self-Dealing, *supra* note 9 (explaining the inefficiencies associated with a fairness test).

17 See id. (reviewing opportunism and inefficiencies associated with majority-of-minority voting).

18 Modern corporate governance relies on a variety of gatekeepers and enforcement measures to constrain agency costs. These include, for example, financial reporting and other disclosure duties, requiring outside auditors and setting standards for their work, and requirements for outside independent directors. These measures could interfere with the controller's ability to manage the firm in a way that limits her ability to capture the full value of her idiosyncratic vision.

19 See generally Guido Calabresi & A. Douglas Melamed, "Property Rules, Liability Rules, and Inalienability: One View of the Cathedral", 85 Harv. L. Rev. 1089 (1972).

20 The need for property rule protection arises from the fundamental justification for allocating control and management rights to the entrepreneur. The controller–entrepreneur is the one who has the unique vision or subjective assessment concerning the project's value (idiosyncratic vision). Any objectively determined compensation for a non-consensual taking will rarely be fair to the entrepreneur. The extensive academic literature on property and liability rules suggests that a property rule protection is appropriate when business vision is present. See Henry E. Smith, "Property and Property Rules", 79 N.Y.U. L. Rev. 1719, 1722–31, 1755–56 (2004).

21 See *Bershad v. Curtiss-Wright*, 535 A.2d 840 (Del. 1987). But see generally Jens Dammann, "Corporate Ostracism: Freezing Out Controlling Shareholders", 33 J. Corp. L. 681, 694 (2007) (explaining an innovative proposal for a regime under which minority investors could force the controller out).

22 Some limits are imposed, however, on the identity of the buyer. See *Harris v. Carter*, 582 A.2d 222 (Del. Ch. 1990) (prohibiting sale of control to a known looter and imposing limited duties of investigation on controlling shareholders). In *Hollinger*, Delaware's Chancery Court allowed the board to use a poison pill to prevent a controlling shareholder from selling his control block. We believe, however, that this holding applies only when the sale of the block is in clear violation of the controller's fiduciary duties. See *Hollinger Int'l., Inc., v. Black*, 844 A.2d 1022, 1085–86 (Del. Ch. 2004) (allowing the board to deploy a poison pill when sale of control was the culmination of an improper course of conduct by the controller and in violation of his contractual obligations).

23 See *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994). For an analysis of this decision and its implications, see John C. Coffee, Jr., "Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?", 21 Del. J. Corp. L. 359, 390–96 (1996).

24 Note that this treatment of the controller differs from that of minority shareholders (or investors at widely held firms). We normally allow management to use rights offerings even when that might coerce investors into a choice between dilution and increasing their investment. For evidence that a controller's need to preserve control affects firm decisions concerning capital structure, see, e.g., Thomas Schmid, "Control Considerations, Creditor Monitoring, and the Capital Structure of Family Firms", 37 J. Banking & Fin. 257 (2013) (finding evidence consistent with the hypothesis that family firms in Germany use firms' capital structure to optimize control over the firm).

25 For the rationale underlying the business judgment rule, see *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 698 (Del. Ch. 2005) ("[R]edress for [directors'] failures . . . must come . . . through the actions of shareholders . . . and not from this Court."); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) ("[D]irectors are better equipped than the courts to make business judgments.").

26 See Lucian A. Bebchuk & Assaf Hamdani, "The Elusive Quest for Global Governance Standards", 157 U. Pa. L. Rev. 1263, 1281 (2009) (advocating for varying governance standards between companies with and without a controlling shareholder, and explaining that controlling shareholders provide the beneficial means and incentive to monitor management).

27 See the stock exchange rules Nasdaq Rule 4350(c)(1) and Section 303(a) of the NYSE's Listing Company Manual.

28 See, e.g., Bernard Black & Reinier Kraakman, "A Self-Enforcing Model of Corporate Law", 109 Harv. L. Rev. 1911, 1947–49 (1996) (describing virtues of cumulative voting as mechanism for minority representation); Carrado Malberti & Emiliano Sironi, "The Mandatory Representation of Minority Shareholders on the Board of Directors of Italian Listed Corporations: An Empirical Analysis", Bocconi Legal Studies Research Paper No. 18, available at http://ssrn.com/abstract=965398 (reviewing minority representation reforms in Italy).

29 See Bernard Black & Woochan Kim, "The Effect of Board Structure on Firm Value: A Multiple Identification Strategies

Approach Using Korean Data", 104 J. Fin. Econ. 203 (2012) (reporting evidence that reforms enhancing director independence positively affected Korean firms); Jay Dahya, Orlin Dimitrov, & John J. McConnell, "Does Board Independence Matter in Companies with Controlling Shareholders?", 21 J. Appl. Corp. Fin. 67 (2009) (finding corporate value is consistently higher in controlled firms with independent directors).

30 Indeed, under NASDAQ Rule 4350(c)(5) a controlled company is exempt from the requirement of Rule 4350(c) of the NASDAQ Marketplace Rule requiring a majority of independent directors on the board. A similar exemption exists under Section 303A of the NYSE's Listed Company Manual.

31 The common-law norm to sell control for a premium is explained clearly in *Zeitlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387, 388–89 (N.Y. 1979) ("It has long been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price."). But see William D. Andrews, "The Stockholder's Right to Equal Opportunity in the Sale of Shares", 78 Harv. L. Rev 505 (1965) (arguing for a sharing of control premium with minority shareholders).

32 See *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 758 (Del. Ch. 2006); *Harris v. Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).

33 See Lucian A. Bebchuk, "Efficient and Inefficient Sales of Corporate Control", 109 Q. J. Econ. 957 (1994).

34 At the same time, our framework could lend support to the equal-opportunity rule. After all, investors in our framework allow the controller to preserve control in order to enable the controller to pursue idiosyncratic vision that would then be shared with investors. When the controller exits the joint investment she takes her pro-rata part of her business vision from the buyer, leaving minority shareholders to wait until the new buyer realizes his idiosyncratic vision. The claim could thus be that the seller must first perform her contractual commitment to the minority (pay the promised share of idiosyncratic vision) before she can ask the minority to enter a new contract with the buyer.

35 See, e.g., U.K. City Code on Takeovers and Mergers, Rule 36 (stating a purchaser crossing 30% triggers a mandatory offer for over 50% of the company); EU Takeover Directive (Directive 2004/25/EC [adoption: codecision COD/2002/0240]) (mandating that "Member States must ensure that [a controller] is required to make a bid as a means of protecting the minority shareholders of that company. Such a bid must be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price").

36 See Bebchuk, *supra* note 33.

37 See Goshen, Controlling Self-Dealing, *supra* note 9, at 408.

38 Id. at 404. See also, Frank H. Easterbrook & Daniel R. Fischel, "Corporate Control Transactions", 91 Yale L. J. 698 (1982) (arguing that legal rules should imitate what parties would bargain for in absence of negotiating costs).

39 See Goshen, Controlling Self-Dealing, *supra* note 9, at 405.

40 To be sure, as Delaware's case law demonstrates, majority-of-the-minority votes may play an important role in scrutinizing self-dealing transactions even under a liability rule. Yet it authorizes courts to approve self-dealing transactions notwithstanding the minority objection, thereby reducing the risk of errors resulting from hold-outs or differences of opinion between the controller and investors.

41 Note that specialized courts would not only enhance minority protection, but also reduce the risk of excessive interference with controlling shareholders' rights. Specialized courts are less likely to err. This in turn would decrease the cost—in terms of undermining controller rights—of rules designed to protect minority shareholders. See, e.g., Luca Enriques, Off the Books, But on the Record: Evidence from Italy on the Relevance of Judges to the Quality of Corporate Law, in Global Markets and Domestic Institutions: Corporate Law in a New Era of Cross Border Deals (Curtis Milhaupt ed., 2003).

42 See generally Goshen, Controlling Self-Dealing, *supra* note 9.

43 *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (discussing elimination of minority shareholders via merger between corporation and its majority owner); *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464, 469 (Cal. 1969).

44 See generally Steven M. Haas, "Towards a Controlling Shareholder Safe Harbor", 90 Va. L. Rev. 2245 (2004).

45 See Dammann, *supra* note 21 (noting that the Delaware test makes it difficult for plaintiffs to establish self-dealing because "while it may be possible to show that the course of action taken by the corporation benefited the controlling shareholder, it is extremely difficult to prove that this advantage came at the expense of other shareholders").

46 See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

47 Id.

48 In a world with no transaction costs the firm's capital structure (i.e., its debt to equity ratio) can be determined using any combination of dividends, leverage, and share issuance, with the same effect on corporate value. Similarly, buying a risky investment with no leverage is the same as buying a solid investment with leverage. See Merton Miller, "The Modigliani-Miller Propositions after Thirty Years", 2 J. Econ. Persp. 99 (1988) (discussing Modigliani and Miller's theorems about the irrelevance of capital structure and dividend policy for corporate value). But, in a world with transaction costs, vision as to a business idea is no different than vision as to capital structure. A controlling shareholder decision to issue new shares and invest in a project should be treated in the same manner as her decision to avoid a project and distribute the money.

49 Any investment offers a combination of risk and expected returns that are calculated based on estimates of future events

or consequences. An investment with an expected return that equals the market pricing of a similar risk offers a zero net present value (NPV). In efficient markets all investments are zero NPV, but to make our point it is sufficient to assume that most of them are. If the expected return on the investment is lower (higher) than the market pricing of the risk that it carries, then it offers a negative (positive) NPV and should be avoided (is a bargain). A controller decision to forego an investment in order to distribute dividends will harm minority shareholders only if the avoided investment was positive NPV (negative NPV should be avoided, and zero NPV leaves shareholders with many alternatives for reinvesting the dividend). Deciding about an investment's NPV would require courts to decide whether the investment is good or bad. Courts cannot make such a decision. Indeed, avoiding such decisions is a major justification for the business judgment rule.

50 Jeffrey N. Gordon, "The Mandatory Structure of Corporate Law", 89 Colum. L. Rev. 1549 (1989) (explaining risk of opportunistic charter amendment).

51 See, e.g., Black et al., *supra* note 10.

52 See *Williams v. Geier*, 671 A.2d 1368, 1378 (Del. 1996) ("[T]here was on this record . . . no non-pro-rata or disproportionate benefit which accrued to the Family Group on the face of the Recapitalization, although the dynamics of how the Plan would work in practice had the effect of strengthening the Family Group's control."); see also *eBay Domestic Holdings v. Newmark*, 16 A.3d 1 (Del. Ch. 2010).

53 See, e.g., Lucian A. Bebchuk & Marcel Kahan, Adverse Selection and Gains to Controllers on Corporate Freezeouts, in Concentrated Corporate Ownership 247 (Randall Morck ed., 2000); Ronald J. Gilson & Jeffery N. Gordon, "Doctrines and Markets: Controlling Controlling Shareholders", 152 U. Pa. L. Rev. 785, 785 (2003); Zohar Goshen & Zvi Wiener, "The Value of the Freezeout Option, Berkeley Program in Law & Economics", Working Paper Series (Mar. 1, 2000); Guhan Subramaman, "Fixing Freezeouts", 115 Yale L. J. 2 (2005).

54 See, e.g., *In re CNX Gas Corp*., 4 A.3d 397 (Del. Ch. 2010) (developing the unified standard for reviewing controlling shareholder freezeout transactions). See also *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013) (holding that freezeout mergers could be subject to the business judgment rule if the controller allows the firm to adopt certain procedural safeguards).

55 For example, an entrepreneur may believe it is no longer possible to implement her vision while complying with the extensive disclosure duties imposed on public companies. In this case, the only way for the entrepreneur–controller to implement her plan and capture the value she attaches to the project is by taking the firm private. See Harry DeAngelo, Linda DeAngelo, & Edward M. Rice, "Going Private: Minority Freezeouts and Shareholder Wealth", 27 J. L. & Econ. 367 (1984) (finding the source of efficiency to be the elimination of the costs attendant to the regulation of public ownership).

56 Assume a liability rule protection against self-dealing under which courts make errors in 20% of the cases: in half of them they approve unfair transactions and in the other half they block fair transactions. When the court approves an unfair transaction, the direct damage is the given transfer of wealth from the minority to the controller (i.e., zero sum transfer), while the indirect damage of under-deterrence is limited due to the small percentage of such mistakes. However, when the court erroneously blocks a fair transaction the damage is not limited to over-deterrence and zero sum transfer, as it also includes the frustration of business vision. The last damage might in some cases be too high to tolerate. Thus, due to the potential incidence of such cases the legal system should contain a safety valve when minority shareholder protections are involved—the ability to take the company private.

57 See Uniform Partnership Act (1997) § 601 (explaining partnership is at will).

58 See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (explaining that allowing controllers to buy out the minority only if they present convincing business reasons for taking the firm private would overly burden controllers, especially given the role played by asymmetric information). See also *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464, 469 (Cal. 1969).

59 See *Coggins v. New England Patriots Football Club, Inc*., 492 N.E.2d 1112 (Mass. 1986) (reviewing controller opportunism to the detriment of minority shareholders under the old "business purpose" test).

60 See also Benjamin E. Hermalin & Alan Schwartz, "Buyouts in Large Companies", 25 J. Leg. Stud. 351 (1996) (calling for protecting the minority with a liability rule to provide the controller with optimal incentives to encourage her entrepreneurial effort).

61 To be sure, a legal regime could adopt of variety of measures to protect the minority, such as approval by special committees of the board and shifting the burden of proof to controllers. Yet, some form of an exit option should be left open even when the minority objects.

62 See *In re CNX Gas Corp*., 4 A.3d 397, 415 (Del. Ch. 2010) ("[A] controller making a tender offer does not have an inalienable right to usurp or restrict the authority of the subsidiary board of directors. A subsidiary board, acting directly or through a special committee, can deploy a rights plan legitimately against a controller's tender offer . . . to provide the subsidiary with time to respond, negotiate, and develop alternatives.").

63 See id.

64 For this reason, we also support the recent decision in *In re MFW S'holders Litig*., 67 A.3d 496 (Del. Ch. 2013) (holding that a

freezeout merger could be subject to the business judgment standard of review if the controller both (i) allowed a special committee of independent directors to veto the transaction; and (ii) conditioned the transaction on a majority-of-minority shareholder vote).

65 See *In re John Q. Hammons Hotels Inc. S'holder Litig.*, Civil Action No. 758-CC, 2009 WL 3165613 (Del. Ch. 2009) (requiring procedural protections in order to apply the business judgment rule); *Ryan v. Tad's Enters., Inc.,* 709 A.2d 682, 689 & n.9 (Del. Ch. 1996), aff'd, 693 A.2d 1082 (Del. 1997) (applying entire fairness when the controlling stockholder received a benefit that was not shared with the minority shareholders in an asset sale).

66 See *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 202 n.95 (Del. Ch. 2006) ("[T]ransactions where the minority receive the same consideration as the majority, particularly a majority entitled to sell its own position for a premium, had long been thought to fall within the ambit of non-conflict transactions subject to business judgment rule protection.").

67 See *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (stating duty-of-loyalty claim could be filed against the parent for negotiating an all-cash transaction to satisfy a liquidity need); *N.J. Carpenters Pension Fund v. Infogroup, Inc.*, 2011 WL 4825888, at *4, *9–10 (Del. Ch. 2011) (denying motion to dismiss when the director, who was also a large stockholder, was in desperate need of liquidity to satisfy personal judgments, repay loans, and fund a new venture). See also *In re Synthes, Inc. S'holder Litig.*, 2012 WL 3594293, at *10 (Del. Ch. 2012) (NO. CIV.A. 6452) ("[I]t may be that there are very narrow circumstances in which a controlling stockholder's immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment.").

68 See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (explaining pro-rata dividend payments are subject to business judgment rule, even if paid for clear benefit of controlling shareholder/parent).

69 See, e.g., Del. Gen. Corp. L. § 262 (providing for appraisal rights); *Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994) (entire fairness).

70 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).